IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

THE UNITED STATES NATIONAL BANK OF CENTRALIA, a Banking Association, and A. R. TITLOW, as Receiver of Said Bank, *Appellants.*	No. 2821.
vs.	
THE CITY OF CENTRALIA, a Municipal Corporation, *Appellee.*	

Petition for Rehearing

WM. R. LEE, City Attorney
for the City of Centralia.

SAMUEL H. PILES and
JAMES B. HOWE,
Solicitors for Appellees.

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Appellee prays that a rehearing be granted in this case.

In the opinion filed this court says:

> "The appellee contends, on the authority of *Commercial National Bank vs. Armstrong,* 148 U. S. 50, that the Seattle bank could not lawfully apply on the Centralia bank's overdraft as it stood on July 14, 1914, the sum of $11,071.64 out of the moneys received for the

appellee's bonds, for the reason that the money so received on the sale of the bonds was a trust fund and that in contemplation of law the Seattle bank has at all times held that sum as the agent of the Centralia bank. A similar contention is made as to the proceeds of three notes aggregating $12,225, which had been guaranteed by the Centralia bank to the Seattle bank, and by the latter charged back to the former. But it does not follow from these facts that the appellee can, in the present suit, recover either of those sums. For, as we have already found, *there is nothing to show that either thereof ever came into the possession of the Centralia bank or its receiver from the Seattle bank,* or that the latter admits liability to pay the same. (Italics ours.) It should be assumed, in absence of evidence to the contrary, that the Seattle bank dealt with the proceeds of the bonds on the understanding that the Centralia bank had complied with the law and had given the statutory bond, which would legalize its possession and right of disposition of the moneys collected on the sale of the bonds."

We submit:

1. That the Seattle bank, knowing that the fund in its hands was a trust fund, could not deduct therefrom the amount which the trustee individually owed to the Seattle bank.

It is not sufficient for one dealing with a trustee to presume that the trustee has power to act in a particular manner and is acting in good faith. The

Seattle bank, knowing that the fund was a trust fund, could not rely upon a presumed authority in the Centralia bank. The Centralia bank could, without executing the bond required by law, act as a collecting agent or trustee for appellee, but before the Seattle bank could lawfully place funds collected by it, and which it knew were trust funds, to the personal credit of the Centralia bank and deduct therefrom its own claims against that bank, the Seattle bank was required to ascertain that the Centralia bank had executed the bond required by law. If the Seattle bank had investigated it would have found that such bond had not been executed and that the trust fund could not, therefore, be converted into an indebtedness from the Centralia bank to appellee. The Seattle bank did not investigate, and having notice that it was dealing with trust funds it was in law charged with knowledge of the facts which investigation would have disclosed. It saw fit to rely upon the direction of the Centralia bank to place the trust fund to its personal credit. The Centralia bank not only had no authority to give such direction, but it had no *apparent* authority to so direct. The transaction between the two banks disclosed a trust relation between the Centralia bank and appellee, which the Seattle bank knew could not be changed except

by the execution of the bond required by law. It failed to inquire whether such bond had been executed, which inquiry if made would have disclosed that the bond had not been executed and, therefore, the direction to place the trust fund to the individual credit of the Centralia bank was a violation of law and a fraud upon appellee.

In the case of *Simmons Creek Coal Co. vs. Doran,* 142 U. S. 417, 438, it was held that the purchaser of land must look to the title papers under which he buys, and is charged with notice of all the facts appearing upon their face, or to a knowledge of which anything there appearing would conduct him. So in the case at bar, the Seattle bank having the bonds in its possession, and the letter of the Centralia bank accompanying them showing the purpose for which these bonds were issued, was bound at its peril to make proper investigation.

In *Wood vs. Carpenter,* 101 U. S. 135, 141, the court quoted with approval a case therein referred to, which said:

> "Whatever is notice enough to excite attention and put the party on his guard and call for inquiry, is notice of everything to which such inquiry might have led. When a person has sufficient information to lead him to a fact, he shall be deemed conversant of it. * * * The presumption is that if the party affected

> by any fraudulent transaction or management might, with ordinary care and attention, have seasonably detected it, he seasonably has actual knowledge of it."

In *Simmons Creek Coal Co. vs. Doran, supra,* the Supreme Court quoted with approval the following from the West Virginia case herein cited:

> "Whatever is sufficient to put a person on inquiry is considered as conveying notice; for the law imputes a personal knowledge of a fact, of which the exercise of a common prudence might have apprised him."

Whatever fairly puts a party upon inquiry is sufficient notice in equity, where the means of knowledge are at hand; and if the party, under such circumstances, omits to inquire and proceeds to do the act, he does so at his peril, as he is then chargeable with all the facts which by a proper inquiry he might have ascertained.

Cordova vs. Hood, 17 Wall. 1 (8), 21 L. Ed. 587.

Augh vs. N. W. M. L. I. Co., 92 U. S. 330 (342), 23 L. Ed. 556.

Martin vs. Webb, 110 U. S. 7, 28 L. Ed. 49.

McClure vs. Oxford Tp., 94 U. S. 429 (432), 24 L. Ed. 129.

Simmons C. C. Co. vs. Doran, 142 U. S. 417 (438), 35 L. Ed. 1062.

Wood vs. Carpenter, 101 U. S. 135 (141), 25 L. Ed. 807.

If the Seattle bank actually knew that such a state of facts existed, could there be any reasonable doubt that the amount deducted from the trust fund by the Seattle bank remained in law on hand as a trust fund, for which the Centralia bank and its receiver must account to appellee? If the Seattle bank illegally deducted from the trust fund the amount of its claim against the Centralia bank then the law regards the deduction as not made, and the receiver must hold the fund in trust just as the Centralia bank held it, and to allow the receiver to acquiesce in the deduction and consequent reduction of the general claims is in effect allowing the receiver to apply the trust fund te the payment of the general indebtedness of the bank, to the injury of the owner of the fund and to the benefit of the general claimants.

It could not be successfully contended that if at the time the receiver of the Centralia bank was appointed there was in the Seattle bank to the credit of the Centralia bank as trustee, a fund collected by the Seattle bank, the receiver of the Centralia bank could consent that such deposit should be applied by the Seattle bank to the extinguishment of an indebtedness of the Centralia bank to the Seattle bank. Such action would be using the trust fund to pay an

individual indebtedness of the Centralia bank to the injury of the beneficiary for whom it was trustee, and for the benefit of its own creditors. Is there any material difference between such action and allowing a receiver to acquiesce in an illegal deduction previously made, which if not acquiesced in would in fact result in the restoration of the trust fund?

2. If, however, the first contention should not be sustained, then we submit that the application of the trust fund by the Seattle bank to its claims against the Centralia bank was as effectual a transmission to and reception by the Centralia bank of the amount so applied as if the specific money *had* been so transmitted and received. If this proposition is correct, then as the Centralia bank at the time of such application and at all times since has had on hand an amount in excess of the sum so applied, appellee is entitled to impress the money in the hands of the receiver with a trust for the amount so deducted.

With much respect we submit that the rule declared in *Commercial National Bank vs. Armstrong,* 148 U. S. 50, has been misapplied in the case at bar.

In the opinion filed your Honors, speaking of the claims of the Seattle National Bank deducted from the proceeds of the water bonds, said:

> "There is nothing to show that either thereof ever came into the possession of the Centralia bank or its receiver from the Seattle bank, or that the latter admits its liability to pay the same."

The proposition now under consideration assumes that the Seattle bank is not liable *to pay to the receiver* the amount which it deducted. It assumes also that the Seattle bank was entitled to presume that the bond required by law had been executed, and that when the Seattle bank made the collection the relation of debtor and creditor existed between the Centralia bank and the Seattle bank, *although the relation between the Centralia bank and appellee was that of principal and agent.*

What is the rule really established in the Armstrong case? Is it the rule announced by the circuit court or that announced by the supreme court?

The circuit court held:

1. That the proceeds of drafts entrusted by the Commercial bank to the Fidelity bank for collection, and by the Fidelity bank to its agent, which were collected by such agent, but the proceeds of which were not remitted to the Fidelity bank prior

to the time the latter failed, constituted trust funds which the Commercial bank could recover as such from the receiver of the Fidelity bank who received them.

2. That similar funds collected by the agent of the Fidelity bank and credited by such agent on debts of the Fidelity bank to such agent prior to insolvency of the Fidelity bank, could not be recovered by the Commercial bank because they had passed into the general funds of the Fidelity bank and could not be traced.

The Supreme Court, in affirming the decree of the Circuit Court, agreed with that court in its conclusion, as well as in the theory upon which its conclusion rested, so far as the first proposition was concerned.

The Supreme Court also agreed with the conclusion of the Circuit Court upon the second proposition, but did not agree with it upon the ground on which the court rested its conclusion.

The Supreme Court said:

> "We think, however, a more satisfactory reason is found in the fact that by the terms of the arrangement between the plaintiff and the Fidelity *the relation of debtor and creditor was created when the collections were fully made.*"

In another part of the opinion the Supreme Court also said:

> "We also agree with the Circuit Court in its conclusion as to those moneys collected by sub-agents to whom the Fidelity was in debt, and which collections had been credited by the sub-agents upon the debts of the Fidelity to them before its insolvency was disclosed; for there the moneys had practically passed into the hands of the Fidelity. The collection had been fully completed. It was not a mere matter of bookkeeping between the Fidelity and its agents. It was the same as though the money had *actually reached the vaults of the Fidelity.*"

The Supreme Court further said in the same opinion:

> "It was the contemplation of the parties and must be so adjudged according to the ordinary custom of banking, that these collections *were not to be placed on special deposit and held until the day for remitting.* (Italics ours.)

It is clear therefore from the opinion in the Armstrong case that if the relation of principal and agent had existed between the Commercial bank and the Fidelity bank instead of the relation being that of debtor and creditor, and if it had been shown that the Fidelity bank, at the time its agents charged against the Fidelity bank the amount of the indebtedness of the Fidelity bank to them, had had on

hand an amount equal to the sum so deducted, *the funds in the hands of the receiver would have been impressed with a trust in favor of the Commercial bank.* The only reason for denying the Commercial bank the right to impress the funds in the hands of the receiver with a trust in its favor *was because the relation of debtor and creditor existed not only between the Fidelity bank and its agents, but because such relation also existed between the Commercial bank and the Fidelity bank.*

In the case at bar, assuming for the sake of argument that the relation of debtor and creditor existed between the Centralia bank and the Seattle bank, such relation did not exist between the Centralia bank and appellee, and this the court has found.

Your Honors say:

> "The Centralia bank, in permitting the proceeds of the bonds to be placed to its credit in the Seattle bank, violated the plain provisions of the law. It had no right to use the money, or to commingle it with its own funds, or to place it to its credit in another bank. *Nat. Bank vs. School District No. 8,* 94 Fed. 705; *Board of Com'rs vs. Strawn,* 157 Fed. 49. The law impresses a trust upon funds so misapplied, and to the extent that the said money or any portion thereof, either in its original or a substituted form, can be traced into the funds which came into the possession of the receiver,

the appellee is entitled to a preference over the general creditors."

The opinion in the Armstrong case says:

"The case of *Marine Bank vs. Fulton,* 69 U. S., 2 Wall. 252, is in point."

In that case Mr. Justice Miller, in delivering the opinion of the court, said: (Italics ours)

"The truth undoubtedly is * * * that both parties understood that when the money was collected the plaintiff was to have credit with the defendant for the amount of the collection, and that defendant would use the money in its business. Thus, the defendant was *guilty of no wrong in using the money because it had become its own.* It was used by the bank in the same manner that it used the money deposited with it that day by its city customers, and the relation between the two banks was the same as that between the Chicago bank and its city depositors."

The supreme court in the Armstrong case then proceeded: (Italics ours.)

"That reasoning is applicable here. Bearing in mind the custom of banks, *it cannot be that the parties understood* that the collections made by the Fidelity during the intervals between the days of remitting *were to be made special deposits,* but on the contrary it is clear that *they intended* that the moneys thus received should pass into the *general funds of the bank and be used by it as other funds,* and that when the day for remitting came the remittance should be made out of such general funds."

Now, in considering the present proposition it is assumed that the relation between the Centralia bank and the Seattle bank was that of debtor and creditor. When the Seattle bank collected the proceeds of the sale of the water bonds and placed them to the credit of the Centralia bank, such proceeds as between the Centralia bank and appellee constituted a trust fund belonging to appellee. If the Seattle bank had made no deduction there would have remained in that trust fund, when the Centralia bank failed, the amount which the Seattle bank did in fact deduct. The Seattle bank did in fact deduct from the fund the amount of the overdraft and the three notes aggregating $23,296.64, which it applied on the indebtedness of the Centralia bank to itself. At the time of such application, and until the failure of the Centralia bank, the Seattle bank had on general deposit an amount in excess of the sum which it deducted. The deduction by the Seattle bank from such trust fund, and the application of the amount so deducted to the payment of the indebtedness of the Centralia bank, at a time when the Centralia bank had on general deposit an amount in excess of that deducted, was "not a mere matter of bookkeeping * * *. It was the same as though the money had *actually reached the vaults" of the Centralia bank.*

(*Bank vs. Armstrong, supra*). In other words, the transaction was exactly the same as though the Seattle bank had remitted the trust fund to the Centralia bank and the latter bank had paid its indebtedness to the Seattle bank by a check on itself, payable out of the funds which it held on general deposit. If the Seattle bank had remitted without deduction and the Centralia bank had paid its indebtedness to the former bank by check of the latter bank on itself at a time when the Centralia bank had on general deposit a sum equal to twice the amount which was in fact deducted by the Seattle bank, is there any doubt that the individual debt of the Centralia bank would be held in law to have been paid by it out of the funds it held on general deposit and that the remainder of such fund would represent the trust fund?

> "No mere bookkeeping between the Fidelity and its sub-agents *could change the actual status of the parties or destroy rights which arise out of the real facts of the transaction.*"
>
> *Armstrong case,* page 58.

The *Armstrong* case answers this question in favor of appellee.

Your Honors have found, as the trial court found, that a state of facts exists in the case at

bar which, had they existed in the *Armstrong* case, would have caused the Supreme Court to reverse the decree of the Circuit Court, such facts found by the trial court and by this court being that under the arrangements between the Centralia bank and appellee the relation was that of principal and agent, *while in the Armstrong case it is that of debtor and creditor.*

Your Honors say in the course of your opinion that, "there is nothing to show that either thereof (the sum of the overdrafts and promissory notes) *ever came into the possession of the Centralia Bank or its receiver, from the Seattle Bank.*" (Italics ours.) And in this connection we wish to call Your Honors' attention particularly to the fact that it is squarely held in the *Armstrong* case that when the sub-agents bank applied a portion of the funds to a discharge of the indebtedness due them from the Fidelity, such application passed the money so applied into the hands of the Fidelity *as fully as if the money had actually reached its vaults.* And it is therefore submitted that the conclusion is inevitable that appellee is entitled, upon the facts found and upon any theory of law applicable to those facts, to impress the funds in the hands of the receiver with a trust in favor of appellee to the extent of $23,296.64 at least.

SET OFF.

Appellees alleged in the fourteenth paragraph of their bill of complaint that the Centralia bank when it failed was the owner and in the possession of certain warrants and bonds therein referred to, which the City was obligated to pay, aggregating something over $9,000.00, and that these warrants and bonds passed into the hands of the receiver, (Record p. 11), and prayed (Record p. 15) that the bank and its receiver be required to make full disclosure of such warrants and bonds, and if upon final hearing it should be held that the City was not entitled to the relief prayed for, that the amount of such warrants and bonds, with accrued interest, be offset against the amounts owing by the bank to the City. The lower court held in its opinion, (appellee's brief, bottom page 18), and as we pointed out in said brief, that inasmuch as the amount traced by appellee into the hands of the receiver exceeded the total balance due the City, after applying the payment made by the bonding company, it was not necessary to determine whether the City would be entitled to set off any part of its claim against the warrants and bonds. Inasmuch, therefore, as the City's right of setoff was not passed upon by the lower court, for the reasons

indicated, nor considered by this court, it is submitted that in any event Your Honors should remand the case with directions to allow this point to be ruled upon in the lower court, or permit the question to be presented to and determined by Your Honors, before the case shall be finally disposed of. Otherwise the right of setoff which the City claims clearly exists, will be lost to it altogether.

In view of the fact that appellees feel that the points presented in this petition have been passed upon and are controlled by the *Armstrong* case, it is respectfully submitted that if this petition shall be denied, Your Honors grant us a reasonable time in which to make application to the Supreme Court of the United States for a writ of certiorari.

Respectfully submitted,

WM. R. LEE, City Attorney
for the City of Centralia.

SAMUEL H. PILES and
JAMES B. HOWE,
Solicitors for Appellees.

The undersigned hereby certifies that he is one of the counsel for the petitioner, and in his judgment the foregoing petition is well founded and is not interposed for delay.

Samuel H. Reis

Of Counsel for Petitioner.